Be prepared: ongoing equity protection

In recent years, LGPS funds saw their funding levels improve on account of strong equity market performance. However, the recent drops in equity markets due to the spread of Coronavirus are a reminder of why we believe it may be beneficial to have continuous equity protection strategies in place that are designed to preserve value in the event of market downturns.

James Sparshott
is Head of Local Authorities within distribution, where he is responsible for managing and developing relationships with LGIM's LGPS clients.

Femi Bart-Williams
is a Senior Solutions and LDI Product Specialist, working with our clients to implement LDI and broader solutions-based investment strategies.

Continued uncertainty about how the global economy will recover and what path such a recovery might take has sparked increasing interest among our clients about how equity protection structures could be used with an aim to mitigate the impact of future downside events on their portfolios. For schemes that already have such structures in place, but where these structures are nearing expiry, the question will also arise as to how to continue that protection.

In this article, we discuss two different approaches that can be used to deliver ongoing equity protection strategies: first, a partnership approach to fixed floor hedges, and second, dynamic protection strategies. The question of which is most suitable for a particular LGPS fund will depend on its specific requirements, including the timeframe for protection and the desired level of engagement versus delegation.

A partnership approach: fixed floor protection

Fixed floor protection is effectively akin to purchasing an insurance policy to protect an equity portfolio value from one actuarial valuation date to the next. Recognising that equity markets could also fall in the run-up to their actuarial valuation date, a number of pension funds have implemented equity protection strategies to ensure that the value of their portfolio on their upcoming actuarial valuation date is protected against specified falls in the equity market. These strategies are designed to insure employers against the risk of increased contributions due to equity market falls over a specific period.

We have developed a framework to work in close partnership with LGPS funds to help them decide when and how to restructure their 'fixed floor protection' as the expiry date of their initial strategy approaches, or as market conditions change significantly. This approach involves restructuring a fund's existing fixed floor protection strategy into another fixed floor strategy, similar to renewing an insurance policy with updated terms to reflect current market conditions and pricing. By continuously restructuring the fixed floor protection when market conditions change significantly or at or close to expiry, the protection can be maintained over time and the embedded value of protection can potentially be crystallised.

Legal & General
INVESTMENT MANAGEMENT

At each restructure, the fund will need to consider whether and how to evolve the protection structure, given changes in market conditions and / or the needs of the fund. For example, when the protection was originally put in place it may have been attractive to pay for that protection by selling away upside on equity gains above a certain level. One year later, it could be the case that it is now more beneficial to retain a greater amount of upside participation and instead pay an upfront premium.

Our equity protection restructuring process is a key part of our ongoing partnership and engagement with our LGPS clients. It consists of:

1. **Daily monitoring** of market levels and value of the protection throughout the term of the protection.

2. **Proactive engagement,** where we contact clients when there are significant market changes that provide an opportunity to review the protection and potentially restructure at that point. By taking a proactive approach to restructuring, timing risk (the risk of restructuring the portfolio when equity markets are less favourable) can be reduced.

3. **A restructure review** scheduled three months prior to expiry of the protection. In these reviews, we work with clients to identify changes to their objectives and refine the protection structure to reflect market conditions and meet their updated needs.

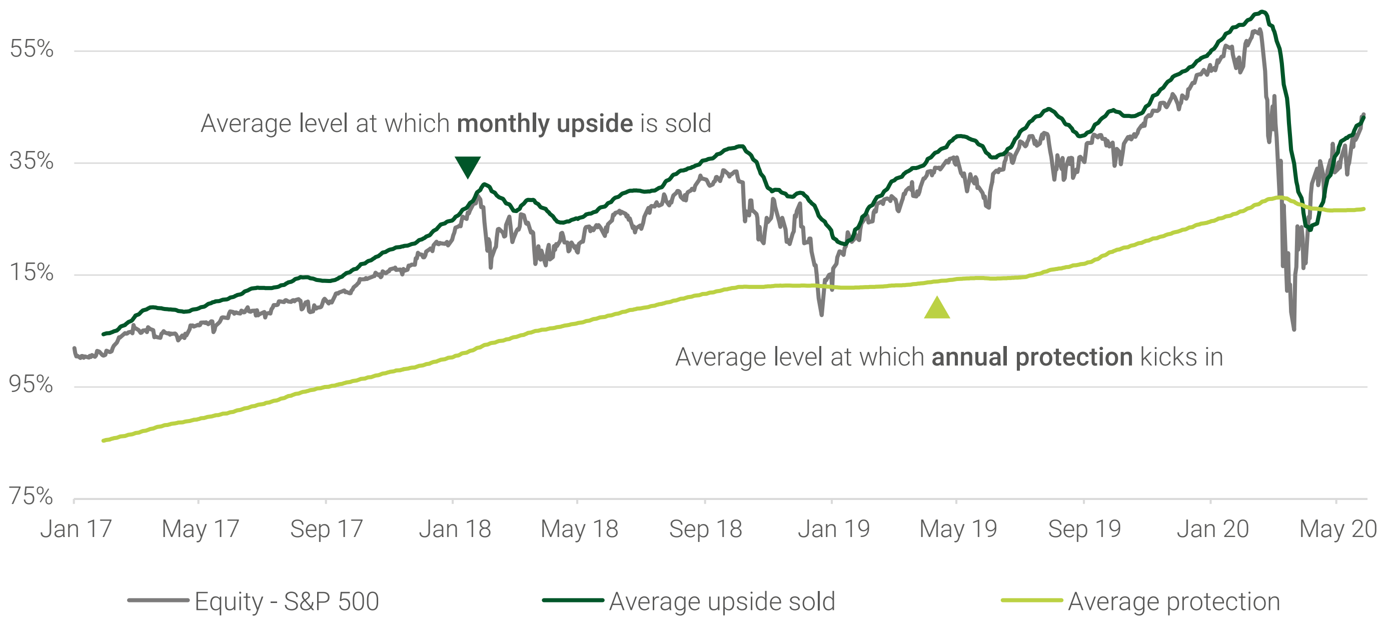
Dynamic protection

The second approach would be to delegate the restructuring of the protection to the investment manager through the use of a dynamic protection strategy. This incorporates a greater degree of delegation which may, in our view, be beneficial for funds looking to reduce their ongoing governance burden.

The structure of dynamic protection strategies is analogous to fixed floor protection strategies, in that they protect from equity markets falling below a certain level (the 'floor') by selling away the returns from equity market growth above a certain level (the 'cap'). However, unlike fixed floor strategies, dynamic strategies have no expiry date. Instead, such strategies automatically renew every day, which can reduce funds' governance burden by ensuring that the strategies adapt to market conditions gradually over time, rather than requiring specific restructuring exercises.

Dynamic protection strategies effectively roll a fixed floor protection each day, as the 'caps' and 'floors' move in line with equity markets, as illustrated in Figure 1. The pale green line shows the level of protection of the dynamic strategy, so the portfolio is protected when equity markets (the grey line) falls below the pale green line. The dark green line shows the cap on equity returns, so the portfolio will not participate in additional returns if equity markets rise above this point.

Figure 1



Source: LGIM and Bloomberg, to 28 May 2020. For illustrative purposes only. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.
Please note, full performance of the S&P 500 Index can be found in Appendix A at the end of this document.

As protection for dynamic strategies is rolled on a daily basis, this mitigates the timing risk inherent in fixed floor protection.

When implementing a dynamic strategy, it is important to ensure transparency of pricing and all costs embedded in the structure. At LGIM, we have developed an innovative approach to implementing these strategies that provides clarity and healthy competition between counterparties, helping us in our aim to deliver better value for money for our clients.

Efficient use of fund assets

For both types of protection strategies, some assets will be required to support the structure. This can be done efficiently using any existing cash, gilt and/or index-linked gilt holdings. Alternatively, for funds without such allocations, an alternative approach could be to synthesise physical equity holdings and use the cash released to support the protection strategy.

Being prepared

Whether your LGPS fund has benefited from an equity protection structure that is now nearing expiry, or whether it is yet to implement one, there are two different approaches that your scheme could use to deliver ongoing equity protection. Fixed floor protection with continuous monitoring and restructuring from time to time involves a partnership approach to agree the best course of action as market conditions change. Alternatively, you can pursue dynamic protection strategies, which incorporate a greater degree of delegation, thereby reducing the ongoing governance burden. At LGIM we believe that it is better to prepare rather than to predict and equity option strategies remain, in our view, a key element of helping LGPS funds manage their journey.

Key risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Appendix A

S&P500 Total Return Index Net Total Return Index five-year performance

Source: LGIM, as at 31/12/2019. Past performance is not a guide to the future.

Year	S&P 500 return
2019	31%
2018	-4%
2017	22%
2016	12%
2015	1%

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

@lgim

Podcast LGIM Talks

The LGIM blog

Key risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Important information

This document is designed for the use of professional investors and their advisers. No responsibility can be accepted by Legal & General Investment Management Limited or contributors as a result of information contained in this publication. Specific advice should be taken when dealing with specific situations. The views expressed in this document by any contributor are not necessarily those of Legal & General Investment Management Limited and Legal & General Investment Management Limited may or may not have acted upon them.

This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation.

As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request.

Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA, www.lgim.com

Authorised and regulated by the Financial Conduct Authority.

DB075